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What You Need To Know About Financing with Synthetic Leases

Nancy R. Little

In a synthetic lease, the lease is indeed synthetic, but the benefits are very real.

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SYNTHETIC LEASES HAVE BECOME one of the hottest financing techniques for credit tenants. This type of "off-balance sheet" financing has been used to finance corporate acquisitions and expansion. Synthetic leases can be used for a variety of assets and have been especially popular for build-to-suit retail, office, manufacturing,

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and distribution facilities, as well as for equipment such as aircraft.

A synthetic lease is a financing arrangement that is treated as a lease for financial accounting purposes and a loan for Federal income tax purposes. If the synthetic lease is properly structured, the lessee/borrower is treated as a lessee under the applicable accounting rules and does not reflect either the debt or the asset on its balance sheet other than in the footnotes. However, for Federal income tax purposes, the lessee is considered the owner of the facility and a borrower under a debt arrangement. Thus, the lessee retains the tax benefits, as described below.

WHAT ARE THE BENEFITS? • The lessee receives off-balance sheet accounting treatment for both the asset and the debt incurred to finance the acquisition and construction of the property. The lessee is treated as the owner of the property for income tax purposes and is entitled to both interest and depreciation deductions. In the case of new construction, the lessee is usually appointed to act as the construction agent for the lessor and controls the design and construction of the facility. However, recent accounting rules (described briefly below) have affected the structuring of most construction agency arrangements. Under the terms of the lease, the lessee also retains operational control of the property.

In most synthetic leases, the potential appreciation in the property remains with the lessee because of the lessee's purchase option, which is described in more detail below. The rent in a synthetic lease arrangement is based on the lessee's credit. The result is lower occupancy costs than in a traditional real estate financing. The transaction generally provides 100 per cent financing for the facility.

The Lessor's Perspective

The lessor views the arrangement as a credit transaction with the lessee retaining all construction and operational risks. In essence, the lessor is making a loan that it expects to be repaid through the rent payable under the lease.

The Lender's Perspective

Lenders typically view synthetic leases as credit transactions, with the asset providing security for the loan arrangement. Often, the lenders are one or more financial institutions that are parties to the lessee/borrower's other revolving credit facilities or loan arrangements.

HOW IS IT STRUCTURED? • The synthetic lease process usually begins with the lessee's identification of a site, an existing facility, or equipment. The lessee may enter into a contract to acquire the asset, but the lessor should acquire title to the property to comply with the accounting rules described below. The lessor then acquires the property for lease to the lessee under a triple net, "bond-type" lease.

Construction Agent

In the case of new construction, the lessee is appointed to act as construction agent for the lessor to design, acquire, and construct the improvements. The lessee is usually responsible for the development of the plans and specifications and the selection of the construction contractor. The lessee must be careful to avoid construction overruns, which may have to be paid for by the lessee if amounts funded by the lessor and the lender are insufficient to complete the project. Payment of such cost overruns by the lessee may affect the accounting treatment of the transaction. As noted above, certain changes in accounting rules have affected the structuring of construction agency arrangements between the lessor and the lessee.

Reimbursement of Construction Costs

Typically, the lessee is responsible for the acquisition, installation, upfit and/or construction of the property. The lessee is reimbursed for acquisition, construction, and other costs by the lessor through a disbursement procedure comparable to that used in a traditional lending arrangement. The lessor's advances to the lessee are funded through a combination of equity investments and loans obtained by the lessor.

Operational Risks

The lessee assumes all risks associated with the ownership and operation of the property, including casualty and condemnation. The lessee is also required to pay all taxes, insurance, utility, and other charges normally paid by a property owner. The lease usually contains a "hell or high water" clause requiring the lessee to pay rent regardless of the occurrence of damage or destruction to or taking of the property. However, indemnifications for pre-existing environmental risks may be limited by accounting rules, as described below.

Principal Financial Terms

The rent is equal to the amount of the debt service and equity

return and is often based on a percentage over the London Interbank Offered Rate ("LIBOR"), a commercial paper rate, or some other index, with little or no amortization. The typical lease term is generally three to seven years and matches the maturity of the debt and the equity. Because most synthetic leases are credit transactions, the documents may include financial covenants by the lessee.

Options at Expiration

At the end of the lease term, the lessee has several options:

- The lease may be renewed if agreed to by both the lessor and the lessee;
- The lessee may elect to purchase the property for a purchase price equal to the amount of the outstanding debt and equity; or
- The lessee may terminate the lease.

If the lessee purchases the property, the asset will be reflected on its balance sheet. (Note: If the lessee desires to continue off-balance sheet treatment of the asset, the lessee may want to consider refinancing the assets by a sale-leaseback.) If the lessee terminates the lease, it must pay the lessor a "contingent rent payment" equal to approximately 85 to 87 per cent of the cost of the facility. This payment is applied to the outstanding debt. The lease typically requires the lessee to market the property. The proceeds of any sale are applied to pay the remaining debt and equity. Any excess sales proceeds are paid to the lessee. The maximum amount of the lessee's exposure for termination is the amount of the contingent rent payment.

ACCOUNTING RULES

• To achieve the benefits of a synthetic lease transaction, the parties must comply with certain accounting rules promulgated by the Financial Accounting Standards Board ("FASB") including the following:

SFAS 13

Statement of Financial Accounting Standards ("SFAS") No. 13 requires that all of the following requirements must be met for the lessee to receive off-balance sheet accounting treatment:

- There can be no automatic transfer of title to the lessee at the end of the lease term.
- Any option to purchase the property by the lessee cannot be at a "bargain" purchase price.
- The term of the lease cannot be 75 per cent or more of the economic useful life of the leased property.

- The present value of the minimum rental payments cannot be 90 per cent or more of the fair market value of the property, determined as of the date of the inception of the lease.

SFAS 98

To obtain the principal benefits of a synthetic lease, a transaction involving real estate should be structured taking into account SFAS No. 98, which applies to sale-leaseback transactions involving real property. Under SFAS No. 98, a lessee that owns real property and sells it to the lessor cannot have any "continuing involvement" after entering into the lease other than in a "normal" leaseback arrangement. SFAS No. 98 cites the following as examples of continuing involvement that would be prohibited:

- An option or obligation to purchase the property by the lessee.
- A guarantee by the lessee of the lessor's investment or return on investment.
- Sharing of appreciation in the property with the lessor.

If SFAS No. 98 applies to the transaction, the lessee would be deprived of some of the principal benefits of a synthetic lease. To avoid the application of SFAS No. 98, the lessee cannot own or acquire title to the property before the inception of the synthetic lease. As noted above, title to the property should be conveyed directly to the lessor by the third party seller. If the lessee owns title to the land, it is still possible to structure a synthetic lease for the improvements if the lessee ground leases the land to the synthetic lease lessor. However, the land would remain on the lessee's balance sheet in that case.

EITF 90-15

The Emerging Issues Task Force ("EITF") of FASB has addressed circumstances under which the lessor and the lessee are "consolidated" for financial accounting purposes. *See* Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions, EITF Abstracts (Emerging Issues Task Force of the Financing Accounting Standards Board), at 623 (1990) ("EITF 90-15"). Under EITF 90-15, the lessee will not receive off-balance sheet accounting treatment if all of the following three tests are met:

- Substantially all of the activities of the lessor involve assets that are leased to the lessee.
- The lessee bears substantially all of the residual risks and enjoys substantially all of the residual benefits of the leased assets.

- The lessor has not made any substantive investment that is at risk during the term of the lease.

ETIF 90-15 proposes three per cent as the minimum equity that qualifies as a "substantive" investment.

Accordingly, the typical synthetic is structured with a three per cent equity contribution. Because at least one of the three tests is not satisfied, the synthetic lease qualifies for off-balance sheet treatment under EITF 90-15.

EITF 96-21

EITF 96-21 limits the use of nonrecourse debt by a lessor to fund its minimum equity contribution. It also provides that structuring fees paid by the lessee to the owners of the lessor must be taken into account for the purposes of applying the 90 per cent test under SFAS No. 13.

EITF 97-1

EITF 97-1 limits the circumstances in which the lessee can indemnify the lessor for pre-existing environmental conditions. If the risk of loss is not remote, such indemnifications could cause the transaction to be treated as a sale-leaseback under FAS 98. In addition, EITF 97-1 describes the circumstances in which the lease arrangement can include defaults that are not related to the lessee's use of the property, such as defaults based on financial performance. Such defaults, among other things, must be customary in financing arrangements, and there must be no indication at the commencement of the lease that a default will occur.

Changes in Accounting Rules

From time to time, FASB has promulgated new policies and procedures affecting the financial reporting for synthetic leases. The lessee's accountants should be consulted for an update before the lessee enters into a new synthetic lease transaction. Two recent examples of accounting rule changes are briefly described below.

EITF 97-10

EITF 97-10 provides that a lessee that bears substantially all of the construction period risks will be treated as the owner of the assets during the construction period. Under these circumstances, the provisions of SFAS No. 98 would apply so the transaction is treated as a sale-leaseback upon completion of construction. EITF 97-10 applies a test similar to the 90 per cent "recovery of investment" test of SFAS No. 13 and includes in the lessee's "maximum guarantee" any amounts that the lessee is or can be required to make during construction. Those amounts include, for example, construction amounts guaranteed by the lessee, equity investments in or loans to the lessor, any obligation to purchase the project or to fund cost overruns, rent paid during the construction period and indemnities or guarantees to the lessor. Certain of these circumstances may result in the lessee being treated as the owner of the lessee even if the 90 per cent test is met.

Consolidation Policy

FASB announced that it may make changes in its consolidation policies and procedures that could result in the "consolidation" of the lessor with the lessee for financial accounting purposes if the lessor is an entity controlled by the lessee. (*See* Exposure Draft, Proposed Statement of Financial Accounting Standards No. 154-D, Consolidated Financial Statements: Policy and Procedures, October 16, 1995.) If adopted, this policy could affect the use of a special purpose entity as the lessor in a synthetic lease if the lessee effectively controls the lessor. FASB has indicated that it will continue discussions in the consolidation area and a new pronouncement is expected shortly.

STRUCTURING FOR ACCOUNTING RULES • Synthetic leases are designed to comply with the accounting rules described above. Although the lessee has an option to purchase the property, it is not intended to be a bargain purchase price, and the transfer is not automatic. In addition, the lessee can elect to return the property to the lessor at the end of the lease term in lieu of purchasing the property.

The "contingent rent payment" or "guaranteed maximum amount" paid by the lessee upon termination of the lease is calculated to be an amount that, when added to the rent paid during the lease term, will not exceed the 90 per cent limitation of SFAS No. 13. This contingent rent payment is approximately 85 to 87 per cent of the cost of the facility.

In real estate transactions, the relatively short term of most synthetic leases complies with SFAS No. 13. The term of the lease could be an issue for a synthetic lease of equipment that has a short useful life.

To avoid the limitations of SFAS No. 98 for real estate transactions, the lessee should not acquire title to the property before the inception of the lease; title should be acquired by the lessor. However, a synthetic lease can be structured using a ground lease if the lessee owns the

land. (Note: SFAS No. 98 only applies to sale-leasebacks of real estate.)

The first test of EITF 90-15 is met in a synthetic lease if the transaction is structured using a special purpose entity, as described below, as the lessor. In addition, the triple-net, bond-type lease meets the second test. However, the third test can be avoided if the arrangement is structured so there is an equity investment of three per cent, the minimum amount necessary to avoid consolidation of the lessor and the lessee for accounting purposes.

Synthetic leases are also evolving to take into account recent accounting pronouncements such as EITF 96-21, 97-1 and 97-10. Any new accounting policies on consolidation could also affect the structuring of a synthetic lease.

WHAT IS THE PREFERRED STRUCTURE FOR THE LESSOR? • The preferred structure for the lessor is a bankruptcy-remote entity. Sometimes a special purpose entity, such as a trust, is formed to act as the lessor. A national bank or state-chartered trust company usually acts as the trustee. However, the parties must carefully structure the entity acting as the lessor to comply with the accounting rules. As noted above, questions have been raised concerning whether a special purpose lessor, that is created solely to own the asset and lease it to the lessee and which is controlled by the lessee, should be "consolidated" with the lessee for accounting purposes. This consolidation would require the lessee to reflect the debt and the asset on its balance sheet.

To avoid this issue, many synthetic leases are being structured with third party lessors or entities such as a leasing affiliate of a bank acting as the lessor, in lieu of a special purpose entity.

Additional accounting rule changes could affect the structuring of the entity used as the lessor in a synthetic lease.

HOW ARE THE LOAN AND EQUITY INVESTMENTS STRUCTURED? • As noted above, the lessor enters into loan arrangements and obtains equity investments to fund the acquisition and construction of the property. In the typical leveraged-lease structure, a lender or group of lenders makes a loan to the lessor on a non-recourse basis.

The debt normally is divided into two tranches:

- An A-tranche, which is structured to be repaid by the "contingent rent payment" described above in the event the lessee elects not to purchase the property; and

- A B-tranche, the holders of which are entitled to a priority payment from the sale of the property.

The A-tranche is in an amount equal to the contingent rent amount, usually about 85 per cent of the facility cost. The B-tranche generally is equal to 12 per cent of such cost. The equity investment makes up the remaining three per cent. The yield on each tranche is priced to take into account the relative priorities of payment. The A-tranche is considered somewhat less risky than the B-tranche, which is tied to the sale of the property and thus bears interest at a higher rate. The yield on the equity component is higher than on the debt, as is characteristic of equity investments. Although credit enhancement is sometimes used, the lessee may want to structure the transaction to avoid a guarantee of the lessor's debt by the lessee. Such a guarantee may require the lessee to take the lessor's debt into account for the purposes of the financial covenants in its revolving credit or other loan arrangements.

WHAT DOCUMENTATION IS NEEDED? • Most synthetic lease transactions include:

- A participation agreement;
- A loan agreement and notes;
- An assignment of lease;
- Documentation for special features of the transaction.

The participation agreement is the mechanism by which all parties agree to participate in the transaction. It typically includes representations and warranties of all of the parties. In addition, the participation agreement includes covenants of the lessee relating to such matters as insurance requirements, financial reporting, environmental compliance, and indemnification. The participation agreement often deals with the conditions to funding and the funding mechanics, as well as the distribution of rental payments between the equity and debt participants.

Loan Agreement and Notes

The loan documents are typical of those found in traditional loan arrangements because the transaction is basically a credit arrangement. The debt is usually nonrecourse to the lessor. As noted above, the loan is typically made in two tranches. The lenders are often a syndicate of banks, with an agent bank or trustee under a trust indenture.

Lease

The structure of the lease is determined in part by the accounting rules noted above. It usually

includes provisions addressing the accounting and tax characterization of the transaction. Because the transaction can be construed as a lease or as a loan for commercial law purposes, the lease usually includes loan-style remedies as well as remedies typically found in a lease. A memorandum of lease is normally recorded and includes a mortgage-style grant of a lien and security interest from the lessee to the lessor in the event the lease is deemed to be a loan arrangement and the lessor is deemed to be a lender.

Assignment of Lease

The lessor usually assigns its interest in the lease to the lender as security for the loan made by the lender to the lessor. Under the assignment, rents are paid directly by the lessee to the lender.

Other Documentation

Some synthetic lease transactions provide for a separate mortgage from the lessor to the lender. There may also be a guarantee of the lease by the lessee's parent or a guarantee of the loan itself by the lessee or its parent. Examine these guarantees closely for compliance with restrictions in the lessee's revolver or other debt agreements on guarantees of the debt of third parties. In build-to-suit transactions, as noted above, there is usually a construction agency agreement naming the lessee as the construction agent for the lessor to design and construct the facility.

HOW ARE THEY TAXED? • For Federal income tax purposes, a synthetic lease is usually characterized as a loan arrangement. The lessee is entitled to deduct interest expense and depreciation. Most state income tax statutes follow the Federal law. Accordingly, if the transaction is treated as a loan for Federal income tax purposes, it will be treated as a loan under state law. The lease usually includes a provision stating that the parties intend the transaction to be characterized as a loan for tax purposes. The documents also contain a tax indemnity by the lessee in the event that, notwithstanding the intent of the parties, the tax treatment as a loan is not upheld.

Because the transaction is nominally a lease, certain other state and local taxes may apply. For example, some jurisdictions impose a "rents tax" on the rents received by the lessor. Sometimes, parties can avoid these taxes by persuading the local taxing authorities that the substance of the transaction is a loan. If not, any such tax payable by the lessor is usually subject to indemnification by the lessee. In structuring the transaction, the parties should investigate whether any such taxes apply.

The recording taxes that are payable depend on the structure of the transaction. If there is a separate mortgage from the lessor to the lender, a mortgage tax may be payable. If there is also an assignment of lease securing the loan, the assignment is usually not separately taxed because it is supplemental to the mortgage as to which the tax has already been paid.

If there is no mortgage securing the lender, the document likely to attract a recording tax is the lease memorandum. Typically, the lease memorandum includes lien rights and remedies because the lease may be treated as a loan instead of a lease for commercial and bankruptcy law purposes. Accordingly, recordation of the lease may result in a tax on the memorandum of lease and/or a mortgage tax. However, there should not be both a lease recording tax and a mortgage recording tax on the same instrument because the transaction is either a loan or a lease, but not both.

If no mortgage is recorded, there may be a question on whether the assignment of lease is exempt from recording tax in certain jurisdictions. If there is no mortgage, the assignment may not be considered supplemental to the lease. Accordingly, in some jurisdictions, such as New York, the assignment may be separately taxed because it secures a separate loan arrangement between the lessor and the lender, whereas the security provided by the lien rights contained in the lease secures the loan arrangement between the lessor and the lessee. Arguably, no recording tax should be paid because the documents, taken as a whole, are really one transaction.

WHAT IF THE LESSOR IS A TRUST? • If the lessor is a trust, state law may not grant an out-of-state trust company the necessary trust powers, and it may be necessary to appoint a separate trustee or co-trustee. Generally, the separate trustee or co-trustee may be an in-state trust company, a national bank, or a natural person. Similar issues may arise if there is a trust indenture appointing a trustee to act on behalf of the lenders. The parties should examine state laws to determine whether either the trust or the trustee is required to qualify to do business. If qualification is necessary, the parties must determine whether exemptions from qualification are available.

WHAT ABOUT SPECIALIZED ASSETS? • In synthetic leases of specialized assets, the parties will have additional

issues to consider. For example, there are specific state and Federal regulations that must be considered for synthetic leases of electric generation or transmission assets and aircraft. Examine these when structuring the transaction.

WHAT TYPE OF TITLE INSURANCE? • In synthetic leases of real estate, title insurers have been willing to insure a synthetic lease alternatively as either a loan or a lease, but not both. The lessor and the lessee should be able to obtain alternative policies or endorsements ensuring the parties as either a lessor or lender (in the case of the nominal lessor) and as either a lessee or owner (in the case of the nominal lessee). The lender usually requests a mortgagee policy.

STATE LAW ISSUES; OPINIONS • Most states have not addressed the characterization of synthetic leases for commercial law purposes. Often, the documents will provide that the transaction is intended to be a lease for financial accounting purposes but a loan for all other purposes, including bankruptcy and commercial law. Local counsel is usually engaged to opine on the enforceability of the synthetic lease documents. In opinion letters, counsel may not be able to state conclusively whether the transaction would be construed by the courts as a lease or a loan. Therefore, the legal opinions usually address the enforceability of the transaction documents alternatively, whether the transaction is characterized as a lease or as loan.

PRACTICE CHECKLIST FOR
What You Need To Know About Financing with Synthetic Leases

A synthetic lease is a financing arrangement that is treated as a lease for financial accounting purposes and a loan for Federal income tax purposes. If the synthetic lease is properly structured, the lessee/borrower is treated as a lessee under the applicable accounting rules, and neither the debt nor the asset is reflected on its balance sheet other than in the footnotes. However, for Federal income tax purposes, the lessee is considered the owner of the facility and a borrower for the debt. Thus, the lessee retains the tax benefits.

• The synthetic lease process usually begins with the lessee's identification of a site, an existing facility, or equipment.

☐ The lessee may enter into a contract to acquire the asset but must make sure that the lessor acquires title to any real property to comply with the accounting rules described above.

☐ However, it may be possible to structure a synthetic lease of equipment that is owned by the lessee.

• The preferred structure for the lessor is a bankruptcy-remote entity. However current and proposed accounting rules will affect the structure of the entity that will act as the lessor.

• Most synthetic lease transactions include:

☐ A participation agreement;

☐ A loan agreement and notes;

☐ An assignment of lease;

☐ Documentation for any special features of the transaction.

• For Federal income tax purposes, a synthetic lease is a loan arrangement. The lessee is entitled to deduct interest expense and depreciation. Most state income tax statutes follow the Federal law. Accordingly, if the transaction is treated as a loan for Federal income tax purposes, it usually will be treated as a loan under state law.

☐ The lease should include a provision that states that the parties intend the transaction to be a loan for tax purposes.

☐ The synthetic lease arrangement usually includes a tax indemnity by the lessee in the event that, notwithstanding the intent of the parties, the tax treatment as a loan is not upheld.

• Synthetic leases must comply with the applicable accounting rules and policies. The lessee should consult with its accounting and tax advisors early in the process.